

## TEST YOURSELF ON LIABILITIES

### True or False

For each of the following statements, circle the T or the F to indicate whether the statement is true or false.

- T   F   1.   Existing liabilities relate to *past* transactions or events, rather than to *future* transactions or events.
- T   F   2.   Liabilities and owners' equity are similar in that both eventually mature.
- T   F   3.   Obligations to pay interest stem from liabilities, not from owners' equity.
- T   F   4.   Some liabilities are recorded in accounting records at estimated amounts, rather than at the actual amount that will have to be paid.
- T   F   5.   The balance of the account Accrued Interest Payable represents unpaid interest charges applicable to past periods.
- T   F   6.   A company's wages and salaries expense is reduced by the amounts of income taxes and FICA taxes withheld from employees' pay.
- T   F   7.   Unemployment taxes are levied directly upon employees.
- T   F   8.   Social Security and Medicare taxes are levied equally upon the employee and the employer.
- T   F   9.   The interest which must be paid on a long-term installment note payable during the next year is classified as a current liability.
- T   F   10.   The principal amount of a long-term installment note payable that will be repaid within the next year is classified as a current liability.
- T   F   11.   Income taxes payable do not become a liability until an income tax return is prepared and filed.
- T   F   12.   A maturing obligation that will be refinanced on a long-term basis is classified as a long-term liability.
- T   F   13.   The primary purpose of an amortization table is to record the gross pay, net pay, and amounts withheld for an individual employee during the year.
- T   F   14.   An amortization table for an installment note payable probably will show increasing amounts of interest expense for each successive period.
- T   F   15.   Unissued bonds may be reported as an asset in the balance sheet since they represent a potential source of cash.

- T F 16. The time value of money concept means that the present value of a future payment is always less than the future amount.
- T F 17. The lower the effective rate of interest required by investors, the lower the price at which a given bond should sell.
- T F 18. If interest rates rise dramatically after bonds payable are issued, the fair market value of the bonds will rise and should be disclosed in notes to the financial statements.
- T F 19. An investor who buys a bond at a premium is willing to earn a lesser rate of interest than the rate stated on the bond.
- T F 20. Material gains and losses on the early retirement of bonds payable are reported in the income statement as extraordinary items.
- T F 21. Total interest expense on a bond sold for less than its face value will be the cash paid as interest less the amortization of the discount.
- T F 22. If a company issues bonds payable at a discount, the rate of interest stated on the bond is greater than the effective rate.
- T F 23. Amortization of a discount on bonds payable increases interest expense and increases the carrying value of the liability.
- T F 24. Amortization of a premium on bonds payable reduces interest expense and reduces the carrying value of the liability.
- T F 25. Estimated liabilities are disclosed in footnotes to the financial statements but are not actually recorded in the accounting records.
- T F 26. Loss contingencies include all types of losses which may result from future events.
- T F 27. The manner in which loss contingencies are presented in financial statements depends upon the degree of certainty involved.
- T F 28. A three-year contract by a baseball team to pay a player a specified salary is classified partially as a current liability and partially as a long-term liability.
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- T F 29. Leases which contain provisions indicating that they are in effect equivalent to a sale and purchase of assets are called *operating leases*.
- T F 30. When lease payments are regarded as rent expense, no liability for the present value of future lease payments appears in the lessee's balance sheet.
- T F 31. When the lessee records an asset and a liability equal in amount to the present value of the future lease payments, part of each lease payment is regarded as interest expense.

- T F 32. A company must disclose in notes to its financial statements the specific terms of every long-term liability.
- T F 33. The debt ratio and quick ratio are of interest primarily to long-term creditors.
- T F 34. Creditors prefer a high debt ratio and a high interest coverage ratio.

### Completion Statements

Fill in the necessary word to complete the following statements:

1. Liabilities are \_\_\_\_\_ from \_\_\_\_\_ transactions.
2. When an employer withholds income tax from an employee, the amount withheld will be credited to a \_\_\_\_\_ account.
3. Most corporate bonds are issued in denominations of \$ \_\_\_\_\_ and pay interest \_\_\_\_\_ a year.
4. For each 9%, 30-year bond issued, Red Car Transport received \$925. The market quotation as shown in the newspaper for these bonds would be \_\_\_\_\_.
5. The \_\_\_\_\_ of a future payment is always (more, less) \_\_\_\_\_ than the future amount because money on hand today can be invested to become a \_\_\_\_\_ amount in the future.
6. Bonds payable reacquired by the issuing company through purchase on the open market at a price (less, greater) \_\_\_\_\_ than carrying value will cause the recording of a gain, whereas bonds reacquired at a price (less, greater) \_\_\_\_\_ than carrying value will cause the recording of a loss.
7. The lessee accounts for the monthly payments on an operating lease by debiting \_\_\_\_\_. The type of lease is often called \_\_\_\_\_ financing because the lessee records no \_\_\_\_\_ for future lease payments.
8. In accounting for a capital lease used to finance the sale of merchandise, the lessor debits \_\_\_\_\_ and credits \_\_\_\_\_ for the \_\_\_\_\_ of the future lease payments. When lease payments are received, the lessor recognizes part of each payment as \_\_\_\_\_ and the remainder as a reduction in \_\_\_\_\_.
9. Ford Motor Company sells automobiles with a five-year limited warranty. At the end of each accounting period, Ford records a liability for the estimated cost of performing warranty repairs on cars sold during the period. The liability for warranty repairs is an example of a(n) \_\_\_\_\_ liability, and recording the related warranty repairs expense in the period in which the cars were sold is required by the \_\_\_\_\_ principle of accounting.

10. In the accounts of the issuing company, the carrying value of bonds equals the face value plus any \_\_\_\_\_ or minus any \_\_\_\_\_.
11. As the discount on bonds payable is amortized, the amount of the net bond liability (increases, decreases) \_\_\_\_\_; as the premium on bonds payable is amortized, the amount of the net bond liability (increases, decreases) \_\_\_\_\_.

### Multiple Choice

Choose the best answer for each of the following questions and enter the identifying letter in the space provided.

- 1. In December, Fallbrook Lumber Co. received an invoice for legal fees rendered in November, payable by January 31. The invoice was not recorded until January 12. As a result of this delay:
- a. Liabilities are overstated at the end of December.
  - b. Legal fees expense is overstated for December.
  - c. The cost principle is violated.
  - d. The matching principle is violated.
- 2. Which of the following is not included among the current liabilities of a manufacturing company?
- a. The portion of a 10-year capital lease obligation that will be paid in the next 12 months.
  - b. The estimated liability for warranty repairs on products sold.
  - c. The liability for income taxes withheld from employees.
  - d. The contingent liability for an unresolved lawsuit pending against the company, to be determined within the next year.
- 3. The bookkeeper failed to classify a note payable as a current liability in preparing Burbank Corporation's balance sheet. As a result of this error:
- a. Burbank Corporation's working capital is understated.
  - b. Burbank Corporation's current ratio is overstated.
  - c. Burbank Corporation's liabilities are understated.
  - d. Burbank Corporation's interest expense is understated.
- 4. The amounts withheld from employees' gross earnings are recorded by the employer as:
- a. Payroll taxes expense.
  - b. Current assets.
  - c. Contra-asset accounts.
  - d. Current liabilities.

- 5. Which of the following would *not* be classified as a long-term liability as of December 31, 2009?
- a. Bonds payable.
  - b. Portion of a 30-year mortgage to be paid off in the next 12 months.
  - c. 5-year Note Payable.
  - d. Debt maturing in March of 2010 that has been refinanced on a long-term basis.
- 6. Albertson Company purchased a parcel of land for \$15,000 and in exchange issued a 10-year installment note for this amount, plus interest at 12% per year. The note is fully amortizing and will be paid in 120 monthly installments of \$215 each. With regard to this installment note, each of the following is true, except:
- a. Albertson's payments on this installment note total \$25,800.
  - b. Albertson's first payment includes \$150 of interest expense.
  - c. Over the 10-year period, Albertson will pay \$10,800 interest.
  - d. Over the 10-year period, Albertson will pay \$18,000 interest.
- 7. Which of the following is not a characteristic of a corporate bond?
- a. Is a highly liquid, transferable investment.
  - b. Has a specified maturity date.
  - c. Represents ownership of the issuing corporation.
  - d. Pays interest, usually semiannually.
- 8. The principal tax advantage of raising capital by issuing bonds instead of capital stock is that:
- a. More investors will be interested in purchasing bonds because they can be issued at a discount and the price will be less than the price of capital stock.
  - b. Interest payments are deductible for income tax purposes; dividends are not.
  - c. SEC approval is required for issuance of capital stock but not for bonds.
  - d. The issuing corporation must pay income taxes whenever capital stock is sold, but only when bonds are sold at a premium.
- 9. On June 1, Eads Corporation issued \$2,000,000 of 10-year, 12% bonds payable. Interest is payable semiannually, each April 1 and October 1. The bonds are issued at par plus accrued interest for the months since the last interest date. The journal entry to record the issuance of the bonds includes:
- a. A debit to Bond Interest Expense of \$40,000.
  - b. A debit to Cash of \$2,040,000.
  - c. A credit to Premium on Bonds Payable of \$40,000.
  - d. A credit to Bond Interest Payable of \$80,000.

- 10. Refer to the data in question 9 above. How much bond interest expense should be reported in Eads Corporation's income statement for the current year ended December 31 with respect to the bonds payable? The "current" year refers to the year in which the bonds were issued.
- a. \$120,000.
  - b. \$80,000.
  - c. \$160,000.
  - d. \$140,000.
- 11. A corporation that wishes to retire its bonds payable:
- a. Must wait until the maturity date.
  - b. Must pay bondholders a price equal to the carrying value of the bonds payable.
  - c. Will recognize an extraordinary loss on the retirement if the price paid is greater than the *face value* of the bonds payable.
  - d. Will recognize an extraordinary gain on the retirement if the price paid is less than the *carrying value* of the bonds.
- 12. Assume that a capital lease is erroneously treated as an operating lease in the accounting records of the lessee. One effect of this error will be:
- a. An overstatement of assets and liabilities
  - b. An overstatement of rent expense and understatement of interest expense and depreciation expense.
  - c. An understatement of rent expense and an overstatement of liabilities.
  - d. None of the above.
- 13. Which of the following would be perceived as *most favorable* by holders of a corporation's debt maturing in seven years?
- a. High current ratio.
  - b. Low debt ratio.
  - c. Low inventory turnover ratio.
  - d. Low interest coverage ratio.
- 14. A *loss contingency* is recorded in the accounts when:
- a. It is reasonably possible that a loss has been incurred and the amount of loss can be estimated.
  - b. It is probable that a loss has been incurred.
  - c. All uncertainty surrounding the loss situation is resolved.
  - d. It is probable that a loss has been incurred and the amount of loss can be reasonably estimated.

- \_\_\_ 15. Loss contingencies relating to pending litigation usually are:
- Disclosed in notes to the financial statements.
  - Shown as current liabilities in the balance sheet.
  - Shown as extraordinary items in the income statement.
  - Not disclosed or recorded until the litigation has been settled.
- \_\_\_ 16. The discount on bonds payable is best described as:
- An element of interest expense on borrowed funds that will be paid by the issuing corporation at maturity.
  - The payment of periodic interest at less than the rate called for in the bond contract.
  - An amount below par which the bondholder may be called upon to make good.
  - An asset representing interest that has been paid in advance.
- \_\_\_ 17. The account Premium on Bonds Payable is best classified in the balance sheet as:
- An addition to bonds payable.
  - A restriction of retained earnings.
  - A deduction from bonds payable.
  - An asset.

### Exercises

1. Listed below are twelve technical accounting terms emphasized in this chapter.

<i>Unfunded pension liability</i>	<i>Loss contingency</i>
<i>Deferred income taxes</i>	<i>Commitment</i>
<i>Bond premium</i>	<i>Unemployment tax</i>
<i>Bond discount</i>	<i>Interest coverage rate</i>
<i>Present value of future cash flows</i>	<i>Capital lease</i>
<i>Principal amount</i>	<i>Applying leverage</i>

Each of the following statements may (or may not) describe one of these technical terms. In the space provided below each statement, indicate the accounting term described, or answer "None" if the statement does not correctly describe any of the terms.

- An element of interest expense included in the maturity value of bonds payable.  
\_\_\_\_\_
- The valuation concept applied to capital lease obligations.  
\_\_\_\_\_
- The portion of a loan payment representing repayment of the original amount borrowed.  
\_\_\_\_\_

- d. A liability that appears in the balance sheet of every company which offers its workers a pension plan.  
\_\_\_\_\_
- e. Financing a business with equity capital.  
\_\_\_\_\_
- f. A liability that results from using straight-line depreciation in financial statements and MACRS in income tax returns.  
\_\_\_\_\_
- g. The risk that losses in future business operations may result in net losses.  
\_\_\_\_\_
- h. A payroll tax shared jointly by employers and employees.  
\_\_\_\_\_
- i. A measure of debt paying ability used primarily by short-term creditors.  
\_\_\_\_\_
- j. A lease agreement in which the lessee treats the lease payments as rental expense.  
\_\_\_\_\_

2. Cleveland Corporation reported the following payroll-related costs for the month of April:

Gross pay (wages expense) .....	\$375,000
Social Security and Medicare taxes.....	28,700
Federal and state unemployment taxes .....	23,250
Workers' compensation insurance .....	12,750
Group health and life insurance benefits .....	16,300
Employee pension plan benefits.....	<u>34,000</u>
Total payroll costs for April .....	<u>\$490,000</u>

Cleveland's insurance premiums for workers' compensation and group health and life insurance were paid for in a prior period and recorded initially as prepaid insurance expense. Withholdings from employee wages in April were as follows:

State income tax withholdings.....	\$ 9,300
Federal income tax withholdings.....	84,100
Social Security and Medicare tax withholdings .....	<u>28,600</u>

- a. Record Cleveland's gross wages, employees withholdings, and employee take-home pay for April.
- b. Record Cleveland's payroll tax expense for April.
- c. Record Cleveland's employee benefit expenses for April.



3. On October 31, year 1, Conrad Township signed a five-year installment note payable in the amount of \$60,000 in exchange for two school buses. The note is fully amortizing and payable in equal monthly installments of \$1,335, which include interest computed at an annual rate of 12%. The first monthly payment is made on November 30, year 1. Complete the amortization table following for the first three payments, and then answer the following questions.

Compute the amount of interest expense on this note recognized by Conrad Township in **year 1**: \$\_\_\_\_\_

Conrad's balance sheet at December 31, year 1, includes a total liability for this note payable of \$\_\_\_\_\_. (Do not separate into current and long-term portions.)

Over the five-year life of the note, how much interest will Conrad Township pay? \$\_\_\_\_\_.

Payment Date	Monthly Payment	Interest Expense	Repayment of Principal	Unpaid Balance
Issuance	----	----	----	\$ 60,000
11/30/year 1	\$1,335	\$_____	\$_____	\$_____
12/31/year 1	\$1,335	\$_____	\$_____	\$_____
1/31/year 2	\$1,335	\$_____	\$_____	\$_____

4. On March 1, year 1, Bestek Corporation issued at par \$8 million of 12%, 10-year bonds payable. Interest is payable semiannually each March 1 and September 1.

The amount of cash paid to bondholders for interest in year 1 is \$\_\_\_\_\_.

Show adjusting entry (if any) necessary at December 31, year 1, regarding this bond issue.

Interest expense on this bond issue reported in Bestek's year 1 **income statement** is \_\_\_\_\_.

Bestek's balance sheet at December 31, year 1 includes bonds payable of \$\_\_\_\_\_ and interest payable of \$\_\_\_\_\_. (Indicate \$0 or "None" if the item is not reported.)

5. On July 1, year 1, Caldwell Company issued \$600,000 of 10%, 10-year bonds with interest payable on March 1 and September 1. The company received cash of \$614,200, including the accrued interest from March 1, year 1.

Bond discount or premium is amortized at each interest payment date and at year-end using the straight-line method. Place the correct answer to each of the following questions in the space provided. (Use the space provided below for computations.)

What was the amount of accrued interest on July 1, year 1? \$\_\_\_\_\_.

What amount of discount or premium was associated with these bonds on the day they were issued? \$\_\_\_\_\_. (indicate discount or premium)

What was the total interest expense for year 1 relating to this bond issue?  
\$ \_\_\_\_\_

7. Shown below is a summary of the annual payroll data for Carter Company:

Wages and salaries expense (gross pay).....		\$500,000
Amounts withheld from employees' pay:		
Income taxes .....	\$60,000	
Social Security and Medicare .....	<u>45,000</u>	105,000
Payroll taxes expenses:		
Social Security and Medicare .....	45,000	
Unemployment taxes .....	<u>12,000</u>	57,000
Workers' compensation premiums .....		15,000
Group health insurance premiums (paid by employer) .....		75,000
Contributions to employees' pension plan (paid by employer and fully funded) .....		30,000
Cost of other postretirement benefits: .....		
Funded .....	\$16,000	
Unfunded .....	<u>\$18,000</u>	34,000

- Compute Carter's total payroll-related expense for the year.  
\$ \_\_\_\_\_
- Compute the company's cash outlays during the year for payroll-related expenses (assume all short-term obligations such as insurance premiums and payroll taxes have been paid).  
\$ \_\_\_\_\_
- Compute the annual "take home pay" of Carter's employees.  
\$ \_\_\_\_\_

8. Listed below are 10 transactions of Marshall-Thomas, Inc.

- On April 1, issued at a discount 20-year bonds payable dated March 1.
- On September 1, made the first semiannual interest payment on the bonds described in a, above, and amortized the discount for five months.
- Made a year-end adjusting entry to recognize interest expense on bonds payable issued at a premium. (These bonds are due in seven years.)
- Immediately following an interest payment date, called bonds issued at a premium at a price above the original issue price, but below current market value. (Assume that all interest expense has been recognized through the date of the call.)
- Due to an increase in interest rates, the market value of the bonds described in a, above, declined substantially.
- Made a monthly payment on an operating lease.
- Made a monthly payment on a capital lease. (Assume all remaining principal payments on this lease are classified as a current liability.)
- Recorded pension expense on a fully funded pension plan, including the remittance of cash to the trustee.

Recorded expenses relating to postretirement costs other than pensions. Fifty percent of these costs are funded immediately and another 25% will be funded in each of the next two years.

Made an adjusting entry to record income taxes expense for the current year, a portion of which is deferred. (Assume that all deferred taxes arise from the methods used in depreciating plant assets.)

Indicate the effects of these transactions upon the elements of financial statements listed below. (Assume the accounts are closed only at year end.) Use the following code letters: I = Increase, D = Decrease, NE = No effect.

Transactions	Income Statement			Balance Sheet			
	Revenue & Gains	Expense & Losses	Net Income	Total Assets	Current Liabilities	Long-term Liabilities	Stockholders Equity
a.							
b.							
c.							
d.							
e.							
f.							
g.							
h.							
i.							
j.							